Do you really know where your assets are, and if they are safe?

Dietmar Roessler
Global Head of Client Segment Asset Owner
BNP Paribas Securities Services

The 2008 financial crisis has changed the rules of the game for global custodians. Asset owners are now asking questions they would not have done previously, especially in an increasingly volatile and globalised world.
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Until October 2008, most of the focus of institutional investors when appointing global custodians was on enabling global investments across all markets, enabling performance measurement and, last but not least, enabling performance-enhancing services such as securities lending and active cash management.

That focus has now changed. The discovery of ‘black swans’ (a disastrous but supposedly rare occurrence) and ‘fat tails’ (abnormal statistical behaviour) has forced investors with a liability horizon of 30-plus years to reconsider. What would have happened to my assets if Barings had not been quickly taken over by ING? What is the impact of assets being ‘frozen’ for six months until final ownership has been established? What is the impact of Madoff itself acting as asset manager, custodian and transfer agent?

More importantly, do I really know who keeps my assets safe and where they are? What is my legal position? How can I minimise the likelihood of asset loss? Do I really understand the risk being run by my managers: investment risk and systemic risk? What is the systemic legal difference between investing in UK, German and Asian assets?

Clearly, Madoff and Lehman changed the focus for everyone: investors, asset managers, regulators and custodians. Since these disasters, asset owners have started to challenge global custodians by asking fundamental questions. What is the real goal of asset owners, and what is the role of global custodians in achieving them? The answers to these questions are simple: asset owners invest for the long term, and the role of global custodians is to safeguard these investments.

The challenge facing the global custodian is to mitigate the risks of asset owners in a world of increased volatility and globalisation, compounded by incoherent rights of transfer of ownership and ownership.

Whether it is a pension fund, insurance or reinsurance company or even sovereign wealth fund, an asset owner’s number one consideration is asset safety—cash safety and the safekeeping of assets held on his behalf. Where is my cash being held? Today, the discussion around cash is very much a traditional banking one: how does the bank hold cash?

Why is cash not held separately as client money? Prior to Lehman Brothers going into bankruptcy in 2008, people did not ask these basic questions—the assumption was that no major bank would ever go under. A global custodian is essentially a bank, and we are seeing a real return to basics. It is therefore not surprising that asset owners are looking in meticulous detail at a global custodian’s balance sheet strength, its credit default swap (CDS) spreads, its credit rating, its net asset shareholder equity and the diversity of its business portfolio.

Financial strength is by no means the only factor considered in the selection process. Another significant consequence of recent upheavals is the emphasis now placed by clients on the strength of operational procedures and controls and the clarification of asset ownership.
Nothing is infallible. Even the strongest operational procedures and controls cannot guarantee 100% accuracy. Whilst a global custody agreement might provide for recourse to the custodian in the event of a fault, a client must be assured of the global custodian’s ability to pay for any liabilities incurred through operational losses—for example if the custodian loses securities, fails to subscribe to corporate events, or fails to convert bonds. The amounts involved are potentially huge, and clients are asking themselves whether their custodian can sustain such claims? If there are multiple claims, how many blows can my custodian absorb? So, whilst securities (unlike cash) do not sit on the global custodian’s balance sheet, financial strength is as important for the safety of assets as it is for the safety of cash.

Segregate to isolate
Clients are demanding the clear segregation of their assets so as to be able to identify these through the entire chain - from the global custodian through the sub-custodian to the Central Securities Depository. The perception is that the identification and ring-fencing of client assets ensures these assets will not form part of the estate available to the liquidator in the event of the insolvency of a global custodian or that of any of its sub-custodians.

The global custodian’s due diligence across its proprietary and sub-custodian network is vital for ensuring the safety of assets and making certain that they are clearly identifiable and segregated from the bank’s proprietary activity in all of the owner’s investment markets. With up to US$30 billion initially tied up in the disentanglement of Lehman Brothers, it is no surprise that segregation procedures come a close second to financial strength in the selection process.

Segregation of assets by the global custodian contrasts with the ‘prime broker’ model used by hedge funds. Here the prime broker holds the assets on its own balance sheet, as security for finance provided, and is normally able to ‘rehypothecate’ or pledge them in order to raise finance. The problems with this model became apparent with the collapse of Lehman’s and the continuing difficulties its hedge-fund clients are having in extricating their assets to enable them to continue in business.

Whilst the global custody model differs significantly from the prime brokerage model post Lehman Brothers, segregation nevertheless remains at the forefront of clients’ minds. It must be stressed, however, that to date no major global custodian has gone into liquidation. Consequently, although there are legal opinions in place supporting the recoverability of assets in all client investment markets, there is no legal precedent proving that segregation will ensure the recovery of assets. Irrespective of the name on the sub-custody or CSD account, the account still belongs to the global custodian. This brings us back to the importance of the financial strength of the global custodian, and its proprietary and sub-custody network.

The industry takes the lead
While there may be uncertainty and divided opinion around the legal framework and no precedent to prove that clients will, unequivocally, be able to recover their assets in case of insolvency of a global custodian, market-driven changes are nevertheless making an impact.

To date, global custody models have primarily been based around co-mingled omnibus accounts, where similar clients are pooled in one sub-account. These days, asset-owning clients are increasingly demanding individual, segregated accounts.
These moves require significant changes to an underlying global custody operating model that is currently based on pooled accounts, with implications for costs and therefore prices. That global custodians are ready to make this investment and clients are willing to pay an increased price reflects how the events of 2008 have changed our perceptions regarding the infallibility of financial institutions—perhaps for the better.

Similar requirements are being imposed through a storm of reform. Most new regulation is aimed at protecting retail or institutional investors and reducing counterparty and systemic risk. Whether it is the Alternative Investment Fund Managers (AIFM) directive, Undertakings for Collective Investment in Transferable Securities (UCITS V) directive, Foreign Account Tax Compliance Act (FATCA), European Market Infrastructure Regulation (EMIR), or many of the other ongoing regulatory changes, there should be increased transparency for both trustees and depository banks.

It is only now that we are starting to ask the question of what ‘safe-keeping’ really means, operationally as well as legally. The result is a strong increase in custodians’ liability and due-diligence obligations, which will probably lead to a new round of consolidation among custodians.

The obligation to replace securities, regardless of one’s own or third-party default, will lead to fundamental changes in the rules of the game within the global custodian industry. There is no reinsurance to pick up this heightened risk obligation, and investors will most likely only be partially willing to absorb the additional cost of security. Consequently, global custodians with an extensive proprietary sub-custody network will have a competitive advantage. They are most likely able to provide guarantees to asset owners within their own organisation and on their own balance sheet.

Contrary to the past, the new wave of industry consolidation will not be about size but about building the right operating model. This will allow the provision of guarantees to global asset owners along the lines currently being drafted in the AIFM and UCITS V directives.

To the point:

- Investors have discovered Asset Safety as a major consideration in their risk management. Finding ways to mitigate these risks requires a Global Custodian partner who provides strong operational protection, powerful legal indemnities framed with a high quality balance sheet.